E COPY

FILED
NOV 23 19
HAROLD B. WILLEY

Supreme Court Of The United States

OCTOBER TERM, 1954

No. 55

INDIANA DEPARTMENT OF STATE REVENUE, GROSS INCOME TAX DIVISION, STATE OF INDIANA, *Petitioner,*

v.

MARK E. NEBEKER, *Respondent.*

ON WRIT OF CERTIORARI TO THE SUPREME COURT OF INDIANA

BRIEF FOR THE PETITIONER

EDWIN K. STEERS,
Attorney General,
CARL M. FRANCESCHINI,
LLOYD C. HUTCHINSON,
Deputies Attorney General,
Attorneys for Petitioner,
219 State House,
Indianapolis, Indiana.

POOR COPY

INDEX

	Page
Reference to Opinions Below	1
Concise Statement of the Grounds on Which the Jurisdiction of this Court is invoked	2
Constitutional Provisions, Statutes and Regulations Involved	4
The Questions Presented	5
Concise Statement of the Case	6
Summary of Argument	9
Argument	11
Domicil As the Basis of An Earnings Tax	11
The Nature of the Income Here Taxed	12
The Nature of the Income In Freeman v. Hewit Distinguished	13
The Effect of the Tax Herein	15
Marginal Stock Transactions Distinguished From Freeman v. Hewit	18
Conclusion	24
Appendix "A"	27

TABLE OF AUTHORITIES

Page

Cases Cited:

Adams Mfg. Co. v. Storen (1938), 304 U. S. 307; 58 S. Ct. 913; 117 A. L. R. 429; 82 L. Ed. 1365 18

Atlantic Coast Line v. Daughton (1923), 262 U. S. 413; 43 S. Ct. 620; 67 L. Ed. 1051 ..... 9, 17

Freeman v. Hewit (1946), 329 U. S. 249; 67 S. Ct. 274; 91 L. Ed. 265 ..... 9, 10, 11, 14

Greenough v. Tax Assessors (1947), 331 U. S. 486, 491; 67 S. Ct. 1400; 172 A. L. R. 329; 91 L. Ed. 1621 11

New York ex rel. Cohn v. Graves (1937), 300 U. S. 308; 57 S. Ct. 466; 108 A. L. R. 721; 81 L. Ed. 866 ..... 9, 11

Richardson v. Shaw (1908), 209 U. S. 365, 374; 28 S. Ct. 512; 52 L. Ed. 835 ..... 10, 18-19

United States Glue Co. v. Oak Creek (1918), 247 U. S. 321; 38 S. Ct. 499; 62 L. Ed. 1135 ..... 10, 16

Ware & Leland v. Mobile County (1908), 209 U. S. 405; 28 S. Ct. 526; 52 L. Ed. 855 22

Western Livestock v. Bureau (1938), 303 U. S. 250, 253; 58 S. Ct. 546; 115 A. L. R. 944; 82 L. Ed. 823 22

United States Constitution:

Article I, Section 8, Clause 3 4

BLEED THROUGH POOR COPY

Page

Statutes:

Title 15 U. S. C. A., Section 78 (g) 21

Title 28 U. S. C. A., Sections 1257 (3) and Section 2101 (c) 4

Indiana Acts of 1937, Ch. 117, as amended, Burns' Indiana Statutes Anno. (1951 Replacement) Vol. 11, Part 2, Section 64-2601 to Section 64-2635 4

Indiana Acts of 1953, Ch. 200, Section 1, Burns' Indiana Statutes Anno. Section 64-2601 (n) 25, 27

Indiana Acts of 1945, Ch. 310, Section 1, Burns' Indiana Statutes Anno. Section 64-2603 (f), (h) and (i) 25, 27, 28

Indiana Acts of 1937, Ch. 117, Section 5, Burns' Indiana Statutes Anno. Section 64-2605 (b) 15, 29

Indiana Acts of 1949, Ch. 277, Section 9, Burns' Indiana Statutes Anno. Section 59-1409 16

Regulations of Indiana Gross Income Tax Division:

Regulation 2805 4

Regulation 1005 5

BLEED THROUGH POOR COPY

Supreme Court Of The United States

OCTOBER TERM, 1954

No. 55

INDIANA DEPARTMENT OF STATE REVENUE, GROSS INCOME TAX DIVISION, STATE OF INDIANA,
Petitioner,

v.

MARK E. NEBEKER,
Respondent.

ON WRIT OF CERTIORARI TO THE SUPREME COURT OF INDIANA

BRIEF FOR THE PETITIONER

REFERENCE TO OPINIONS BELOW

The majority opinion, decision and judgment of the Indiana Supreme Court (R., pp. 27, 28) and the dissenting opinion of EMMERT, J., in which DRAPER, C. J. concurred (R., pp. 28-32), as yet unreported officially, are unofficially reported in 116 N. E. (2d) 104 and 105, respectively, of the West Reporter System.

CONCISE STATEMENT OF THE GROUNDS ON WHICH THE JURISDICTION OF THIS COURT IS INVOKED

The issue of alleged interstate commerce immunity as applied to the receipt of respondent's capital gains herein was raised in the Court of first instance in the Vermillion Circuit Court of Vermillion County, Indiana, by the filing of respondent's second amended complaint on October 1, 1951 (numerical paragraph 16 thereof.) (R., pp. 14-19). Said complaint is based solely upon the allegation of interstate commerce immunity. This cause was put at issue in the trial court by the filing of petitioner's answer of denial. (R., p. 20).

Upon the admission and conclusion of evidence, and submission of the cause, the Court of first instance entered its general finding that the allegations of respondent's complaint were true and judgment for respondent that the income herein was immune from taxation by virtue of the Commerce Clause. (R., p. 25).

The question of alleged interstate commerce immunity was pursued by petitioner from the Court of first instance by the filing of petitioner's Motion for New Trial. (R., pp. 25, 26), which was overruled by said Court. (R., p. 26). Thereafter, the question of alleged interstate commerce immunity was submitted to the Indiana Supreme Court by the filing of the Transcript of the Record, together with petitioner's Assignment of Errors. (R., p. 1). After briefing and argument, the Indiana Supreme Court, on December 15, 1953, by a divided Court, entered its written opinion, decision and judgment, based solely on the ques-

BLEED THROUGH POOR COPY

tion of interstate commerce immunity, in which said majority opinion it concluded as follows:

> "* * * As the Supreme Court of the United States pointed out in the case of *Freeman v. Hewit, supra,* the vital question in each case is whether the *sale itself* was in the field of interstate commerce. The evidence of the transaction may float around the world or stay safely buried in a gilded vault on Wall Street. It seems to us to make no decisive difference.
>
> "The trial court held that the facts in this case bring it within the rule laid down in the *Freeman Case.* We think the trial court was correct.
>
> "Judgment affirmed." (R., p. 28) (116 N. E. (2d) at p. 105.)

EMMERT, J. dissented with an opinion; DRAPER, C. J. concurred in dissent. (R., pp. 28-32) (116 N. E. (2d) pp. 105-107).

Thereafter, on January 4, 1954, and within the time allowed by the Rules of the Supreme Court of Indiana, the petitioner herein filed its Petition for Rehearing (R., p. 32), which was denied by the Indiana Supreme Court on January 27, 1954, (R., p. 34), EMMERT, J. and DRAPER, C. J. dissenting. The opinion, decision and judgment of the Indiana Supreme Court was rendered by the highest Court of the State of Indiana from which a decision could be had and is a final judgment, subject to no further review or correction in any other tribunal of the State of Indiana.

Petition for Writ of Certiorari and Transcript of Record were filed in this Court on April 27, 1954 as No. 731, October Term 1953, and granted on October 14, 1954. (R., p. 37).

The issue in this case and the holding of said Court, of which reversal is sought by this Honorable Court, draws

in question the validity of a state statute and regulations thereunder on the grounds of being repugnant to the United States Constitution, viz.: The Commerce Clause, Article I, Section 8, Clause 3.

The statutory provisions believed to sustain the jurisdiction of this Honorable Court are: Section 1257 (3) and Section 2101 (c) of Title 28 of the U. S. Code Annotated.

CONSTITUTIONAL PROVISIONS, STATUTES, AND REGULATIONS INVOLVED

The constitutional and statutory provisions and regulations involved are as follows:

Article I, Section 8, Clause 3 of the United States Constitution, which reads as follows:

> "The Congress shall have power * * * to regulate commerce with foreign nations, and among the several states, and with the Indian tribes; * * *".
> U. S. C. A., Constitution, containing Article I, Section 1 to Article I, Section 9, p. 200.

The statute involved is the Indiana Gross Income Tax Act of 1933, as amended, (Indiana Acts of 1933, Ch. 50; Indiana Acts of 1937, Ch. 117, and succeeding amendatory acts), which may be found complete with amendments to date in Burns' Indiana Statutes Anno., (1951 Replacement) Vol. 11, Part 2, Section 64-2601 to Sec. 64-2635, both inclusive. Pertinent provisions of said act are reproduced herein as Appendix "A" of this brief.

The regulations of petitioner especially pertinent to the precise issue herein and under which the tax was paid, as last promulgated on April 27, 1946, are as follows:

> "REGULATION 2805: MARGINAL TRANSACTIONS. Any taxpayer dealing on margin will

BLEED THROUGH POOR COPY

report his gross earnings from such transactions. Gross earnings in such cases will be the gross profits realized, whether received or credited to his account, where securities or commodities are sold for any amount in excess of cost, without any deductions for losses incurred when securities or commodities are sold for an amount less than cost, and also without any deductions for taxes, brokerage commissions or other expenses incident to the transaction."

"REGULATION 1005: GROSS EARNINGS MEANS GENERALLY the gross profits on individual transactions before costs of effecting the transactions are deducted, and with reference to sales of property such gross earnings means and includes only the gross difference between the cost of such property, as of the date of its final acquisition by the taxpayer, and the *gross* receipts resulting from the sale of such property. It also includes gross commissions, interest, dividends, fees, etc. In computing "gross earnings" no deductions can be taken for losses on any transactions. "Gross Earnings" is stipulated as being the "Gross Income" for taxation of banks, trust companies, building and loan associations, brokers, dealers in securities, finance companies, dealers in commercial paper, and persons engaged in the business of lending money or credit. (Sec. 1n; Sec. 1p.)"

The foregoing regulations in substance are the same as the corresponding regulations which have been in effect since July 1, 1934, excepting only minor variations in wording and identified by different numbers.

THE QUESTIONS PRESENTED

I

Does interstate commerce immunity extend to the taxation of capital *gains* derived from marginal stock trans-

actions, such gain consisting of the gross *difference* between the cost of the property upon acquisition by the taxpayer and the gross receipts from its sale, with no deduction permitted for transactions in which the taxpayer may have sustained a loss by sale of corporate stock at less than the purchase price, the recipient of such gains being a resident of the State seeking to tax?

II

Are capital gains from marginal stock transactions derived from interstate commerce when there is no evidence that the recipient of such gains ever owned specific, identifiable shares, or that any stock ever crossed state lines, or that such recipient ever performed any act in interstate commerce?

CONCISE STATEMENT OF THE CASE

This action, commenced in the Vermillion Circuit Court of Vermillion County, Indiana (47th Judicial Circuit of Indiana), and thereafter appealed to the Supreme Court of Indiana, is one to recover taxes imposed upon the receipt of capital *gains* by respondent, domiciled and residing in Indiana, derived from his marginal stock transactions.

The facts are embodied in two Stipulations of Facts entered of record in the trial court, and may be found in the record submitted herewith at pages 5 to 12, inclusive ("Stipulation of Facts") and Pages 22 and 23 (supplementary "Stipulation").

So much of the facts as are necessary for a complete understanding of the questions herein presented are as follows:

Respondent is a resident of Indiana (R., p. 9). During the years 1944, 1945 and 1946, respondent consummated

BLEED THROUGH POOR COPY

certain stock transactions through the stock brokerage firms of Thompson and McKinnon and/or James E. Bennett and Company (R., pp. 9-11). In each of said transactions, the purchase of said stock was made by the broker, the stock credited to the account of respondent on the books of the broker and the cost thereof debited to the account of respondent on the books of the broker kept in the State of Indiana. The stock certificates were never ordered out or transferred to respondent, nor were they ever delivered to respondent in a street name, but the property interest in such stock was maintained in what is commonly called a margin account. (R., pp. 11, 12).

The respondent had the right to receive the dividends paid on such stock, the right to vote or direct the vote of such stock in stockholders' meetings, and the right to sell the same and receive the proceeds. The rights of ownership thereto are subject only to the terms of a pledge to the broker for the payment of any indebtedness which might be owing by respondent to the broker. (R., p. 12).

Upon orders of respondent, sales of such stock were made by the broker, who debited the stock sold to the account of the respondent, and the proceeds therefrom were credited to the respondent's account on the books of the broker kept in the State of Indiana. (R., p. 12). Such transactions and the gains derived therefrom were as follows:

Years	*Number of Sales*	*Shares Sold*	*Gains*
1944	32	3310	$ 8,839.74
1945	31	3200	14,699.82
1946	13	1250	7,425.44

(R., pp. 9-11).

For each of said years, respondent reported such *gains* in his tax returns as "capital gains without deductions or

losses (margin account)". (R., p. 6). The amount of tax paid on said "gains" and of which a refund is sought herein are as follows:

Year	*Amount Claimed as Refund*
1944	$ 88.39
1945	146.99
1946	74.23

(R., pp. 7, 8, 10, 11).

In addition to the tax herein involved, respondent paid intangibles tax to the State of Indiana on the securities herein, the liability for which is not in issue. (R., p. 23).

BLEED THROUGH POOR COPY

SUMMARY OF ARGUMENT

I

Respondent, *a resident of Indiana,* was engaged through his Indiana broker in buying and selling corporate stock on the New York Stock Exchange by means of *margin accounts.* Securities bought by him (or those of like kind and value) were *held in New York* as security for that part of the purchase price advanced by the broker. Upon the aggregate *gains* from each sale in excess of cost, Indiana asserts the right to impose a tax of 1% upon such income. The *domicilary* state of the owner of property located in another state may constitutionally exact a tax upon *earnings* derived from such property. (*New York ex rel. Cohn v. Graves* (1937), 300 U. S. 308).

II

The principles of *Freeman v. Hewit* (1946), 329 U. S. 249, have here been applied erroneously to the taxability of income, materially different in *character* from that involved in said case. Rather than gross receipts, the *tax base* herein is the aggregate *gross earnings* arising from each transaction in which securities are sold for any amount *in excess of cost,* such earnings consisting of the *difference* between the cost of the securities upon acquisition by the taxpayer and the gross receipts from their sale, without deductions for transactions in which the taxpayer may have sustained a loss by sale of securities at less than the purchase price. (*Atlantic Coast Line v. Daughton* (1923), 262 U. S. 413, 422, footnote 6).

III

Because the tax levy is not a constant, fixed sum but is a *percentage* (1%) of *only that portion* of gross receipts

representing gross earnings, the tax alone cannot transform such gain into loss, as would be the case if the percentage were applied to the entire gross receipts from sale. (*United States Glue Co. v. Oak Creek* (1918), 247 U. S. 321, 328, 329).

IV

Further, *marginal* stock transactions are substantially distinguishable from those in *Freeman v. Hewit* (1946), 329 U. S. 249. Marginal stock buying did *not* transfer either the ownership or possession of *specified, identifiable* securities to the respondent. Securities bought by the respondent (or those of like kind and value) were pledged to secure the broker's advancement and therefore *remained with the New York broker* until sold. (*Richardson v. Shaw* (1908), 209 U. S. 365, 374-376). Because the stock certificates remained with the New York broker, *interstate transmission of the certificates* (upon which Freeman-Hewit was grounded) *was lacking* from the instant fact pattern. The only interstate incidents herein, consisting of interstate communications between the New York and the Indiana broker, bear no greater weight in establishing these as interstate sales than if it were New York real estate which respondent was selling.

ARGUMENT

Domicil As The Basis Of An Earnings Tax

New York ex rel. Cohn v. Graves (1937), 300 U. S. 308; 57 S. Ct. 466; 108 A. L. R. 721; 81 L. Ed. 866, established that the State of New York could impose its net income tax upon income of New York residents received from rents of land located in New Jersey, and from interest on bonds held in New Jersey secured by mortgaged real estate in New Jersey. The principles of said case were founded upon the protection afforded by New York to the recipient of the income in his person, in his right to receive the income and his enjoyment of it when received, said rights and privileges attaching to domicil within the taxing state. Said tax was also upheld because it was one on net income, thereby being apportioned to the ability of the taxpayer to pay it.

In *Greenough v. Tax Assessors* (1947), 331 U. S. 486, 491; 67 S. Ct. 1400; 172 A. L. R. 329; 91 L. Ed. 1621, decided within six months after *Freeman v. Hewit* (1946), 329 U. S. 249, the principles enunciated in New York ex rel. Cohn v. Graves, were recognized as still being applicable, in the following language:

> "• • • The domiciliary state of the owner of tangibles permanently located in another state, however, may require its resident to contribute to the government under which he lives by an income tax in which the income from the out-of-state property is an item of the taxpayer's gross income. It is immaterial, in such a case, that the property producing the income is located in another state. *New York ex rel. Cohn v. Graves,* 300 U. S. 308." (331 U. S. at p. 491).

In the instant case, respondent, *a resident of Indiana,* was engaged through his Indiana broker in buying and selling corporate stock on the New York Stock Exchange by means of margin accounts. Securities so bought by him remained in New York to secure that portion of the purchase price advanced by the broker. Upon the aggregate *gains* from each sale in excess of cost, Indiana imposed a tax of 1%.

Although New York ex rel. Cohn v. Graves was decided upon a contended violation of the Fourteenth Amendment (an issue not here raised), rather than upon a contended violation of the commerce clause, that case also recognized that a tax by the domiciliary state on net income is not forbidden by the Commerce Clause, irrespective of the source of the income. (300 U. S. 308, 313, 314). Therefore, said case is authority for the proposition that neither the Fourteenth Amendment nor the Commerce Clause forbid the domicilary state from taxing net income derived from property located in another state. Indiana here asserts that its right to tax the gross earnings here in question is constitutionally no less than the right of New York to tax under the circumstances in New York ex rel. Cohn v. Graves. Further, the fact that the income-producing property is located without Indiana creates no greater constitutional inhibition than was present in said case.

The Nature of the Income Here Taxed

It is abundantly certain from the record in this case that gross receipts from sale were not the basis upon which the tax was imposed. *In no instance herein does Indiana assert the right to tax the entire gross receipts from sale. No part* of the gross receipts from those transactions in which the taxpayer sold securities *for less than their initial cost to*

BLEED THROUGH POOR COPY

him entered into the picture. From those transactions in which securities were sold for any amount *in excess of their cost to the taxpayer, only that part* of such gross receipts equivalent to the *gross excess* of the selling price above the cost was subject to the tax herein. That it was gross gains which were reported and upon which the tax was paid is evidenced from an examination of the record (pp. 9, 10 and 11), in which only those transactions from which gains were derived are shown, and which indicates *gains* ranging from $7.30 per one hundred shares of Johns-Manville stock sold on November 22, 1944 to $2489.49 per one hundred shares of Celanese Corporation stock sold on December 19, 1945. The stipulation admits that the income taxed herein consisted of *gains rather than gross receipts from sale.* (R., pp. 5-12).

The Nature of the Income in Freeman v. Hewit Distinguished

In pursuance of the statute which requires that a claimant state in his claim for refund the reasons for such claim, the respondent filed his claim for refund in which the reasons alleged by him at that time were solely as follows:

> "The reasons why Claim for Refund should be allowed, are as follows (explain fully):
>
> "Establishment of the non-taxibility of sales of securities executed outside of the state of Indiana by decision of the United States Supreme Court in the case of Freeman Trustee v. Hewit.
>
> "The above amounts were reported and paid on sales of securities without the state of Indiana.
>
> (Signature) Mark E. Nebeker."
>
> (R., p. 8).

In respondent's complaint filed in the lower court, the sole theory of recovery, as alleged in numerical paragraph

sixteen (16) thereof, was that the tax was imposed upon gross receipts from business conducted in commerce between the State of Indiana, the State of New York or other States of the United States, and that such tax was an illegal burden upon commerce between the State of Indiana and other States of the United States in conflict with Article I, Section 8 of the Constitution of the United States, and that the State of Indiana was prohibited from taxing such gross income under the Gross Income Tax Law of 1933, and laws amendatory thereof and supplemental thereto. (R., pp. 18, 19)

The majority opinion of the Indiana Supreme Court relied solely upon *Freeman v. Hewit* (1946), 329 U. S. 249, 67 S. Ct. 274, 91 L. Ed. 265, and concluded:

> "The trial court held that the facts in this case bring it within the rule laid down in the *Freeman case.* We think the trial court was correct." (R., pp. 27, 28).

Respondent's theory of recovery and the decision of the Indiana Supreme Court by its majority, having been bottomed upon the Freeman-Hewit decision, we respectfully submit that the special facts herein remove that case as a conclusive authority to determine the taxability of the *gross earnings* herein. In the instant case, during the three years involved, the respondent sold 7760 shares of stock, all at prices exceeding their cost to the respondent. From the sale of such 7760 shares, in all of which gross earnings arose, the total *gains* derived thereby were approximately $30,000.00 and the tax imposed thereon and paid by respondent was approximately $300.00 (R., pp. 8-11).

As illustrative of the substantial difference between this case and the Freeman-Hewit case, imagine what the tax at the same rate (1%) might have been if the tax had been

POOR COPY

imposed upon aggregate sales prices, not only of the 7760 shares sold at a gross profit, but also including such shares as may have been sold at a loss. Such was the situation in Freeman-Hewit, in which this Court condemned a tax at 1% upon the aggregate of all gross sale prices from sales of securities totaling $65,000.00, irrespective of whether the transactions were profitable or otherwise. The record herein does not indicate whether there were transactions in which the respondent suffered a loss, but it is clear that the gross receipts from such transactions, if any there be, were not included in the tax base. The record is clear not only that the 7760 shares reported were sold at prices in excess of cost, but also that the $30,000.00 reported and upon which tax was paid was gain rather than gross receipts from sale.

Petitioner therefore asserts that there is a manifest, substantial, and controlling difference between this case and Freeman-Hewit.

The Effect of the Tax Herein

As heretofore stated, only those transactions in which the selling price exceeds the cost give rise to any tax liability. In such transactions, gross receipts from sale are not the tax base, but only a necessary factor in determining the extent of gross earnings. In computing gross earnings, the *acquisition cost* of the securities to the respondent, is *always deductible.* Thus, *the largest and most variable factor from which a loss could be sustained* in these transactions, *is allowed as a deduction.* Respondent also is accorded a $1,000.00 annual exemption in computing the amount of income subject to tax. (Indiana Acts 1937, Chapter 117, Section 5 (b), Burns' Indiana Statutes, Section 64-2605 (b). (R., pp. 10, 11). We do not profess that other

deductions are allowed. Regulation 2805 specifically provides that, other than costs of the securities upon acquisition, no other deductions are allowed whether for taxes, brokerage commissions or other expenses incident to the transaction. Therefore, we do not claim that the tax is imposed upon final net income remaining after the deduction of all conceivable expenses pertaining to the transaction. However, we do say that with respect to the transactions giving rise to such tax liability, *the tax alone cannot transform such gain into loss, as would be the case if the tax were imposed upon gross receipts from sale.*

The tax herein is a *percentage* of the gross earnings, having been imposed upon this type of income at the rate of 1% from 1933 to the present date, except for the period from July 1, 1949 to December 31, 1953, during which period Indiana imposed a surtax of ¼ of 1% for the payment of a Veterans' Bonus. (Indiana Acts of 1949, Ch. 277, Sec. 9, Burns' Ind. Stat. Anno. Sec. 59-1409) The Veterans' Bonus tax raised sufficient revenue for the payment of such Bonus and was terminated by Executive Order effective January 1, 1954. Except for the above surtax, now removed, the basic tax has been 1% upon this type of income for over twenty years. Since such tax is a *percentage* instead of a constant, fixed amount, and applicable only to gross earnings, we do not see how it is possible for the tax *alone* to transform those gains into losses.

Conceding that the tax herein is not precisely the same as that in *United States Glue Co. v. Oak Creek* (1918), 247 U. S. 321; 38 S. Ct. 499; 62 L. Ed. 1135, we do, however, contend that the principles established in the United States Glue Co. case are more applicable herein than those stated in Freeman-Hewit.

POOR COPY

The decision in United States Glue Co. v. Oak Creek was based upon a "manifest and substantial" difference in effect between a tax measured by gross receipts and one measured by net income, it being stated that such difference afforded a convenient and workable basis for distinguishing a direct and immediate burden upon commerce from a burden which is only indirect and incidental. The United States Glue Co. case reiterates that a tax upon gross receipts affects each transaction in proportion to its magnitude, irrespective of whether it is profitable or not, and that such a tax may make the difference between profit and loss. Similar to the tax sustained in the United States Glue Co. case, the tax herein has not the same deterrent effect because no tax arises unless a gain is shown, and the tax cannot be heavy unless the profits are large. The operation of the tax in the instant case is such that it distributes the cost of government among those best able to bear that burden, which is the underlying principle upon which net income taxes are based.

Petitioner also submits as applicable to the issues herein the principles announced in *Atlantic Coast Line v. Daughton* (1923), 262 U. S. 413; 43 S. Ct. 620; 67 L. Ed. 1051, in which the main question was whether a North Carolina net income tax law violated the commerce clause *because it did not allow certain deductions.* The taxpayer there contended that the law violated the commerce clause because it did not allow as deductions certain items, such as interest on its indebtedness, the expense of leasing trackage from other railroad companies and the expense of renting joint facilities and locomotives. The method of determining net taxable income used by North Carolina reflected net taxable income in the amount of $437,769.52. By contrast, the method for determining net taxable income used by the

taxpayer there reflected a net loss of $254,290.22. This difference was attributable to the fact that the taxpayer had certain expenses which it sought to deduct from its operating revenue, which North Carolina did not allow as deductible items. This case recognized that that income tax was not imposed upon gross receipts from interstate commerce and further that the term "net income" is not one of rigid meaning; that what deductions are to be made from gross income to ascertain net income, are details largely a matter of governmental policy as to which various states differ in their views at different times and as to different classes of taxpayers. (262 U. S. 413, 422, ft. note 6).

Marginal Stock Transactions Distinguished From Freeman v. Hewit

In the case of Freeman v. Hewit, the stock certificates were held by the taxpayer *in Indiana* and, after notification by his broker that a purchaser had been found, said securities were brought to the Indiana broker and *transmitted to New York.* It was held that there was no material difference between an interstate sale of intangibles and an interstate sale of tangibles. The stock certificates were there compared to the machines in *Adams Mfg. Co. v. Storen* (1938), 304 U. S. 307; 58 S. Ct. 913; 117 A. L. R. 429; 82 L. Ed. 1365, it being stated that it was no less interstate commerce because the property sold *and transmitted across state lines* was stock certificates rather than tangible personal property.

In contrast with Freeman v. Hewit, the buying and selling of corporate stock by means of margin accounts, is handled in a materially different manner. *Richardson v.*

POOR COPY

Shaw (1908), 209 U. S. 365, 374; 28 S. Ct. 512; 52 L. Ed. 835, explains in detail the operation of marginal stock transactions and the relation between the broker and the customer, as follows:

> "* * * There has been much discussion upon this subject in the courts of the Union. The leading case, and one most frequently cited and followed, is *Markham v. Jaudon*, 41 N. Y. 235, a case which was argued by eminent counsel and held over a term for consideration. The opinion in the case is by Chief Judge Hunt, afterwards Mr. Justice Hunt of this court. He summarized the conclusions of the court as follows:
>
> > "The broker undertakes and agrees:
> >
> > "1. At once to buy for the customer the stocks indicated;
> >
> > "2. To advance all the money required for the purchase beyond the ten per cent furnished by the customer;
> >
> > "3. To carry or hold such stocks for the benefit of the customer so long as the margin of ten per cent is kept good, or until notice is given by either party that the transaction must be closed. An appreciation in the value of the stocks is the gain of the customer and not of the broker;
> >
> > "4. At all times to have in his name and under his control ready for delivery the shares purchased, or an equal amount of other shares of the same stock;
> >
> > "5. To deliver such shares to the customer when required by him, upon the receipt of advances and commissions accruing to the broker; or,

"6. To sell such shares, upon the order of the customer, upon payment of the like sums to him, and account to the customer for the proceeds of such sale.

"Under this contract the customer undertakes:

"1. To pay a margin of ten per cent on the current market value of the shares;

"2. To keep good such margin according to the fluctuations of the market;

"3. To take the shares so purchased on his order whenever required by the broker, and to pay the difference between the percentage advanced by him and the amount paid therefor by the broker.

"The position of the broker is twofold: Upon the order of the customer he purchases shares of stocks desired by him. This is a clear act of agency. To complete the purchase he advances from his own funds, for the benefit of the purchaser, ninety per cent of the purchase money. Quite as clearly he does not in this act as an agent, but assumes a new position. He also holds or carries the stock for the benefit of the purchaser until a sale is made by the order of the purchaser or upon his own action. In thus holding or carrying he stands also upon a different ground from that of a broker or agent whose office is simply to buy and sell. To advance money for the purchase, and to hold and carry stocks, is not the act of the broker as such. In so doing he enters upon a new duty, obtains other rights, and is subject to additional responsibilities . . . In my judgment the contract between the parties to this action was in spirit and effect, if not technically and in form, a contract of pledge." (209 U. S. pp. 374-376).

The margin requirements at present are those as prescribed in Title 15, U.S.C.A., Section 78-(g). Unlike Freeman v. Hewit and as recognized by Richardson v. Shaw, the securities bought by the customer (or those of equal value and like kind) remain with the broker as security for the broker's advancement. Of importance, therefore, is the fact that the securities remain in the state of the mart so that interstate transmission of the same is not required of the customer to complete their sale.

In the instant case, the record is silent as to the respondent ever owning or possessing specific, identifiable shares of stock in Indiana. Respondent's complaint, numerical paragraph eleven (11) thereof (R., p. 17), alleges as follows:

> "• • • Plaintiff's ownership of said corporate stock was never transferred to plaintiff's name on the stock register of the various corporations, nor were the certificates representing and evidencing said corporate stock, bearing assignments in blank, in so-called "street names", delivered to plaintiff, but were at all times kept and possessed by plaintiff's brokers in the State of New York."

The stipulation stated:

> "• • • The stock certificates were never ordered out or transferred to the claim of the claimant. Neither were they ever delivered to the claimant in a "street name", but the property interest in the stock was maintained in what is commonly called a margin account." (R., pp. 11, 12).

Thus, *there is no showing that the respondent transmitted stock certificates across state lines to consummate these marginal transactions.* Instead, it is affirmatively

established that the securities were never delivered to respondent and that his property interest therein was maintained in what is commonly called a margin account.

The instant case is somewhat similar to *Ware & Leland v. Mobile County* (1908), 209 U. S. 405; 28 S. Ct. 526; 52 L. Ed. 855, which dealt with the selling of cotton future contracts on margin. That case emphasizes that there was no contract for nor any actual delivery of cotton; that no specific cotton was contemplated and that if delivery were required, the cotton could have been acquired and delivered in one and the same state. That case upheld a state license tax on the broker engaged in multistate activities because there was not necessarily any movement of commodities in interstate traffic. In that case, as in this, the customers' activities are those of local communication with a local broker. Clearly, the transmission of stock certificates across state lines, as in Freeman-Hewit, is a material element lacking from the fact pattern herein.

As stated in Western Livestock v. Bureau (1938), 303 U. S. 250, 253; 58 S. Ct. 546; 115 A. L. R. 944; 82 L. Ed. 823:

> "That the mere formation of a contract between persons in different states is not within the protection of the commerce clause, at least in the absence of Congressional action, *unless performance is within its protection*, is a proposition no longer open to question." (Emphasis supplied.)

The use of interstate communications to effect the transactions herein is of no greater importance than if the respondent were to have used such interstate communications to effect the sale of real estate owned by him and located in the State of New York.

Recognizing that marginal transactions are subject to federal regulation to prevent the excessive use of credit,

such regulation is directed to the level of the Securities Exchange and only indirectly upon the customer. However, we do not understand that the existence of federal regulation determines in all cases that the activities of individuals thereby affected are immune from state taxation unless the state tax conflicts with the paramount federal regulatory power. For example, the coverage of the Federal Wage and Hour Law is broad to protect many individuals performing local activities insofar as taxation is concerned. Since performance in interstate commerce was not shown to have been required of the respondent, his activities are similar to those of an individual dealing with a federally regulated bank, whether within or without the taxing state. Insofar as we are able to determine, in Freeman-Hewit, the taxpayer was held to have been engaged in interstate commerce because of the interstate shipment of his wholly owned securities, rather than for the reason that he was dealing with a federally regulated broker.

CONCLUSION

This case presents still another phase of the Indiana Gross Income Tax Act of 1933, as amended,—in our opinion unlike the *Adams, Freeman-Hewit* or any other cases decided under that Act. Long before Freeman-Hewit, in fact, since July 1, 1934, income from marginal transactions has been taxed on a gross earnings as distinguished from a gross receipts basis. For years, other classes of taxpayers have by statute been accorded the gross earnings basis. Throughout the years, the Indiana General Assembly has extended the gross earnings basis to numerous classes of taxpayers, both before and since *Freeman-Hewit*, such amendments often having been sponsored by the class affected.

This basis is believed to be justified by the fact that the activities of such classes of taxpayers result in a very narrow margin of profit, over which the taxpayer in many instances has no control. For example, dealers in securities are limited in their income-producing possibilities by the fact that the market fluctuates from day to day, in some instances, only a fraction of a point. Certain of such taxpayers by various regulatory measures, Federal and State, are limited in the amount of interest or other income which they may charge. Others are limited to a specific margin fixed by certain regulatory bodies over which such taxpayer has no control. The classes of taxpayers accorded the gross earnings basis do not have that free rein of other taxpayers to enter into a competitive field without restriction, who have only the law of supply and demand by which to fix their selling prices, which, in some instances, may reflect a profit varying from forty to one hundred percent of the cost of the merchandise sold. *Also taxpayers accorded the gross earnings basis often do not receive, control nor have*

the right to control the entire gross proceeds of the transaction as in this case; in other words, that which they receive is gain rather than gross proceeds. It is for the above reasons that the Act defines gross income in many instances to mean gross earnings.

For instance, Section 3(h) of the Act, Burns' Indiana Statutes, Section 64-2603(h) specifically accords the gross earnings basis to public terminal grain handlers stating that "gross earnings shall be construed to mean the gross receipts from sales of such grain and soy beans, less the cost of grain and soy beans sold during such period, without any deduction of any other kind or character."

Section 3 (i) of the Act, Burns' Indiana Statutes, Section 64-2603 (i) specifically accords the gross earnings basis to sales of grain when the federal government regulates both purchase and selling price, imposing the tax at one percent (1%) on the "specific margin between such purchase-price and such sale price * * *."

Section 1(n) of the Act, Burns' Indiana Statutes, Section 64-2601(n) accords the gross earnings basis to banks, trust companies, building and loan associations, brokers, dealers in securities, finance companies, dealers in commercial paper, persons engaged in the business of lending money or credit, and that Section was amended by the Indiana Acts of 1953, Chapter 200, p. 753 to now include investment companies regulated under the Federal Investment Company Act of 1940, as amended.

The decision of the Indiana Supreme Court, by its majority opinion, is, therefore, of more vital importance than the precise issue herein. The import of that decision is to invalidate the gross earnings basis of the tax with re-

spect to all taxpayers so reporting, wherever interstate, extra-state or multistate elements are present.

If the dividends received by respondent from the same securities herein are subject to the tax, as the Indiana Act indicates, even though the securities may have been held outside Indiana, we believe that the gains herein are as equally real income, in the true sense of that term, and not subject to interstate commerce immunity.

WHEREFORE, your petitioner respectfully prays that the majority opinion, decision and judgment of the Indiana Supreme Court be in all things reversed, and for such other relief in the premises as to this Honorable Court may seem meet and just.

Respectfully submitted,

EDWIN K. STEERS,
Attorney General,
CARL M. FRANCESCHINI,
LLOYD C. HUTCHINSON,
Deputies Attorney General,
Attorneys for Petitioner,
219 State House,
Indianapolis, Indiana.

APPENDIX "A"

Pertinent provisions of the Indiana Gross Income Tax Act bearing on issues presented herein, are as follows:

Section 1 (n):

> "In the case of banks, trust companies, building and loan associations, investment companies, regulated under the federal investment company act of 1940 as amended, brokers, dealers in securities, finance companies, dealers in commercial paper, and persons engaged in the business of lending money or credit the term 'gross income' shall be deemed to mean gross earnings, but only in respect to that part of the total gross income of such persons which is derived from the businesses and activities enumerated in this subsection."
>
> (Acts 1933, ch. 50, Sec. 1, p. 388; 1937, ch. 117, Sec. 1, p. 604; 1941, ch. 140, Sec. 1, p. 418; 1943, ch. 144, Sec. 1, p. 425; 1945, ch. 143, Sec. 1, p. 311; 1947, ch. 370, Sec. 1, p. 1471; 1953, ch. 200, Sec. 1, p. 747.) Burns' Indiana Statutes Anno., Section 64-2601 (n). (1951 Repl.)

Section 3 (f):

> "With respect to that part of the gross income of every person received from operating any bank, trust company, building and loan association, insurance and/or casualty company, finance company, small loan company, or any other business of a similar nature, including all others mentioned in subsection (n) of section 1 (Sec. 64-2601), the tax shall be equal to one (1%) per cent of such part of the gross income."
>
> (Acts 1933, ch. 50, Sec. 3, p. 388; 1937, ch. 117, Sec. 3, p. 604; 1941, ch. 140, Sec. 2, p. 418; 1945, ch. 310, Sec. 1, p. 1380.) Burns' Indiana Statutes Anno., Section 64-2603 (f). (1951 Repl.)

Section 3 (h):

"With respect to that part of the income of every person which is derived solely from the purchase and sale of whole grain and soy beans by such person in the capacity of a public terminal grain handler engaged in the business of receiving, processing, storing, and merchandising whole grain and soy beans in markets having full transit privileges, the tax shall be equal to one (1%) per cent of the gross earnings, computed upon an annual basis, derived from such sales of grain and soy beans, Provided, however, that for the purpose of this subsection only, gross earnings, shall be construed to mean the gross receipts from sales of such grain and soy beans less the cost of grain and soy beans sold during such period, without any deductions of any other kind or character. Provided, further, that nothing herein contained shall be construed to authorize the computation of the tax due under this act, measured by gross receipts of such persons from storage, cleaning, service or handling charges, or any other receipts except those from sales of whole grain and soy beans on a gross earnings basis."

(Acts 1933, ch. 50, Sec. 3, p. 388; 1937, ch. 117, Sec. 3, p. 604; 1941, ch. 140, Sec. 2, p. 418; 1945, ch. 310, Sec. 1, p. 1380.) Burns' Indiana Statutes Anno., Section 64-2603 (h). (1951 Repl.)

Section 3 (i):

"With respect to that part of the income of every person which is derived solely from the purchase and sale of whole grain and/or soy beans when the United States government, by any authorized officers, department of (or) agency, has by any law, rule, regulation or directive, prescribed both a purchase-price and a sale price thereby creating a specific margin between such purchase-price and such

sale price, the tax shall be equal to 1% of such specific margin."

(Acts 1933, ch. 50, Sec. 3, p. 388; 1937, ch. 117, Sec. 3, p. 604; 1941, ch. 140, Sec. 2, p. 418; 1945, ch. 310, Sec. 1, p. 1380.)
Burns' Indiana Statutes Anno., Section 64-2603 (i). (1951 Repl.)

Section 5 (b):

"In computing the amount of tax imposed under the provisions of this act for any year, there shall be deducted from the gross income of any taxpayer not provided for in subsection (a), an amount of one thousand dollars ($1,000.00). Each such taxpayer who is taxable hereunder upon gross income for any fractional part of the tax year shall be entitled to a deduction of that part of one thousand ($1,000.00) dollars, which bears the same proportion to that amount which the period of time during which the taxpayer is subject to tax bears to an entire year. In computing such period of time, a fraction of a month shall be disregarded unless such fraction is more than a half a month, in which case it shall be taken as a whole month. Where quarterly returns are filed as provided in this act, a proportionate part of the deduction provided for in this subsection may be claimed and allowed on each quarterly return."

(Acts 1933, ch. 50, Sec. 5, p. 388; 1937, ch. 117, Sec. 5, p. 604.)
Burns' Indiana Statutes Anno., Section 64-2605 (b). (1951 Repl.)